DOCUMENT RESUME

ED 378 875 HE 028 024

AUTHOR Schenet, Margot A.
TITLE The Federal Direct Student Loan Program. CRS Report for Congress.
INSTITUTION Library of Congress, Washington, D.C. Congressional Research Service.
REPORT NO CRS-95-110-EPW
PUB DATE 6 Jan 95
NOTE 22p.; For a related document, see HE 028 025.
PUB TYPE Legal/Legislative/Regulatory Materials (090)

EDRS PRICE MF01/PC01 Plus Postage.
DESCRIPTORS College Students; Educational Attitudes; Federal Aid; *Federal Programs; Financial Support; Government Role; Loan Repayment; Postsecondary Education; Program Descriptions; Program Evaluation; *Program Implementation; Public Policy; Student Financial Aid; *Student Loan Programs
IDENTIFIERS *Direct Lending

ABSTRACT

This report discusses the establishment and operation of the Federal Direct Student Loan Program (DL), enacted by Congress in 1993 to partially replace the existing federal guaranteed student loan programs with a single program that would make loans directly to postsecondary students through their schools. The DL program will be phased in over a 5-year period so that it will originate at least 60 percent of all new federal loans to students during the 1998-99 academic year. The new DL program includes four different repayment plans: standard, graduated, extended, and income-contingent. The development of the income-contingent plan was particularly controversial, since it was estimated that 52 percent of borrowers would be subject to negative amortization at some time during the loan life, increasing their debt. Other concerns about the DL program include its impact on the general availability of loan aid for students, the ability of the U.S. Department of Education to administer the program, and the program costs. (MDM)

****
* Reproductions supplied by EDRS are the best that can be made *
* from the original document. *
****

95-110 EPW

ED 378 875

CRS Report for Congress

The Federal Direct Student Loan Program

Margot A. Schenet
Specialist in Social Legislation
Education and Public Welfare Division

U.S. DEPARTMENT OF EDUCATION
Office of Educational Research and Improvement
EDUCATIONAL RESOURCES INFORMATION CENTER (ERIC)
☑ This document has been reproduced as received from the person or organization originating it
☐ Minor changes have been made to improve reproduction quality
• Points of view or opinions stated in this document do not necessarily represent official OERI position or policy

January 6, 1995

Congressional Research Service • The Library of Congress

BEST COPY AVAILABLE

The Congressional Research Service works exclusively for the Congress, conducting research, analyzing legislation, and providing information at the request of committees, Members, and their staffs.

The Service makes such research available, without partisan bias, in many forms including studies, reports, compilations, digests, and background briefings. Upon request, CRS assists committees in analyzing legislative proposals and issues, and in assessing the possible effects of these proposals and their alternatives. The Service's senior specialists and subject analysts are also available for personal consultations in their respective fields of expertise.

BEST COPY AVAILABLE

THE FEDERAL DIRECT STUDENT LOAN PROGRAM

SUMMARY

In 1993, the Clinton Administration proposed a major change in the **delivery** of Federal student loans by converting the guaranteed student loan programs, called Federal Family Education Loans (FFEL), into direct loans, made by the Government to students through their schools. The Student Loan Reform Act (SLRA), part of P.L. 103-66, established the new Federal Direct Student Loan Program (DL), to be phased in, beginning in academic year 1994-95. The Secretary of Education selects schools to participate in the DL program so that loans at such schools shall constitute 5% of total new student loan volume in academic year 1994-1995, 40% in academic year 1995-1996, 50% in academic years 1996-1997 and 1997-1998, and 60% in academic year 1998-1999. Beginning in the 1996-1997 academic year, the Secretary may exceed the specified percentage.

One-hundred and four schools are currently participating in the first year of the DL program, accounting for an estimated $1 billion plus in new loan volume in academic year 1994-95. The final list of 1,391 schools selected for year 2 brings the total for participation in 1995-96 to 1,495 schools. Together, these schools represented approximately $5.4 billion in loan volume in FY1992.

Loan terms and conditions for Direct Loans are generally the same as those in the FFEL programs; Federal Direct Stafford, Federal Direct PLUS, and Federal Direct Consolidation loans are available. The new DL program, however, provides four different types of repayment plans: standard; graduated; extended; and income-contingent repayment. Under the income-contingent repayment (ICR) plan, the borrower annually repays an amount based on the total amount of the borrower's Direct Loan, adjusted gross income, and family size for a period up to 25 years. Development of the income-contingent repayment plan was particularly controversial. The Administration sought to make the plan as attractive as possible to borrowers by keeping the percentage of income assessed and the monthly payment amounts as low as possible. Others were concerned that too low monthly payment amounts would tempt students into paying excessive amounts of interest or going further into debt when their monthly payments are not sufficient to cover the interest on their loan (unpaid interest would be added to their principal, resulting in negative amortization). ED estimates that under ICR, the average length of repayment would be 14 years, and 52% of the borrowers would be subject to negative amortization.

ED's plans for implementation of Federal Direct Consolidation Loans also aroused considerable concern, because of the potential for a dramatic shift in loan volume from FFEL to DL loans. In December 1994, ED announced that it was reassessing its plan for implementing Direct Consolidation Loans.

While few disagreed that the guaranteed loan system was too complex and costly as it operated prior to passage of the SLRA, differences continue over whether the appropriate course for Federal policy is direct loans, requiring an expansion of government's role, or changes to improve the guaranteed loan system. Concerns about operation of the new DL program include its impact on the general availability of loan aid for students, the ability of ED to administer the program, and the costs involved.

TABLE OF CONTENTS

BACKGROUND 1
The Guaranteed Student Loan System 1
Direct Loans 2

PHASE-IN TO DIRECT LOANS 3
Year 1 4
Year 2 5
Repayment Options 8
Income-Contingent Repayment Plan Provisions 10
Consolidation Loans 12
Program Administration 13

IMPACT AND CONTINUING ISSUES 15
Access 15
Implementation/Fraud and Abuse 16
Cost and ED Administration 17

LIST OF TABLES

TABLE 1. Characteristics of Direct Loan Schools, Year 1 and Year 2 6
TABLE 2. Federal Direct Stafford/Ford Loan Limits 8

THE FEDERAL DIRECT STUDENT LOAN PROGRAM

BACKGROUND

In 1993, the Clinton Administration proposed a major change in the delivery of Federal student loans by converting Federal Family Education Loans, made by private lenders but guaranteed by the Government, into direct loans made by the Government to students through their schools. A similar proposal had been debated in the 102nd Congress during the reauthorization of the Higher Education Act (HEA), which authorizes the loan programs and other types of Federal student aid under its title IV. Apprehension concerning the potential effects of such a change on student aid programs and on schools, as well as strong opposition by the Bush Administration had led to the establishment of a pilot program to test the concept. The Clinton Administration plan, which was included in the House version of the Omnibus Budget Reconciliation Act of 1993, would have repealed the pilot program and proceeded with a complete phase-in to direct loans by the 1997-1998 academic year. As enacted by Congress, the Student Loan Reform Act (SLRA), part of the Omnibus Budget Reconciliation Act, P.L. 103-66, included a compromise on a direct loan phase-in with at least 60% of all student loan volume being direct loans by the 1998-1999 academic year.

The Guaranteed Student Loan System

Federal Family Education Loan (FFEL) programs provide the majority of Federal aid available for postsecondary students to attend colleges, universities and trade and technical schools. About 16% of undergraduates use FFEL borrowing to finance educational costs. In FY1993, FFEL programs supported $16.5 billion in loans to undergraduate students, parents of dependent undergraduates, and graduate and professional students. Several types of FFELs are available to support postsecondary student expenses: Federal Stafford loans, subsidized or unsubsidized, available to undergraduate and graduate students; and Federal PLUS loans, available to parents of dependent undergraduates. Federal Supplemental Loans for Students (SLS) were available through the 1993-94 award year. Payments on these and other student loans may be combined under a Federal Consolidation loan.[1]

The guaranteed student loan system is complex largely due to the number of participants involved in the origination and servicing of the loans. FFEL loans are made by some 7,800 private lenders using their **own capital.** Private lenders are willing to make these loans because they are insured under the terms of the program against loss through borrower default, death, disability, and bankruptcy. Another benefit of the FFEL

---

[1]For further detail on the FFEL programs see: U.S. Library of Congress. Congressional Research Service. *The Federal Family Education Loan Programs*. CRS Report for Congress No. 94-810 EPW, by Margot A. Schenet. Washington, 1994. (Hereafter cited as U.S. Library of Congress, *The Federal Family Education Loan Programs)*

program assures lenders a minimum rate of return, given market conditions, through a "special allowance" payment to supplement the borrower's interest.

FFEL lenders receive the insurance on their student loans from among some 46 public or private nonprofit guaranty agencies operating in each State as a guarantor under an agreement with the Federal Government. The Federal Government effectively reinsures these agencies by reimbursing them for default claims they pay lenders. Guaranty agencies administer much of the FFEL programs. They oversee lender compliance with Federal rules, assist lenders in default prevention activities, and are the first collectors of defaulted loans. A secondary market provides liquidity to lenders through buying their FFELS or lending them money to make more loans. The largest secondary market entity is the Student Loan Marketing Association (Sallie Mae), which is a Government Sponsored Enterprise (GSE -- a private corporation chartered under Federal law to serve a public purpose) founded in 1972 specifically to purchase student loans. Other secondary market participants include State or nonprofit agencies largely financed through tax-exempt bonds, and several large banks.

The Federal Government will pay an estimated 12 cents for each FFEL dollar loaned in FY1995. Major costs include reinsurance payments it makes to guaranty agencies for defaults, and paying interest for needy students while they are in school and during grace and deferment periods. Special allowance payments are not a Federal cost currently, but could become significant if interest rates rise. Federal costs are partially offset by collections on defaulted loans and other Federal receipts, including origination and reinsurance fees. Federal costs for FFELs are entitlements.

Direct Loans

What are direct loans and what is the rationale for changing from the existing system? In a general sense, direct loans are loans made with **Federal capital** and owned by the Federal Government: the Federal Government is effectively the banker. In the context of student loans, most direct loan proposals have postsecondary schools act as the originator of the loan on behalf of the Federal Government. The loans would subsequently be serviced by Federal contractors or, as some have proposed, the U.S. Internal Revenue Service (IRS).

Prior to passage of the SLRA, the Clinton Administration and other direct loan supporters contended that the existing guaranteed loan system, with its middleman players, is unnecessarily costly and complex. Supporters argued that direct loans would save the Government billions of dollars because the Federal cost of delivering loans to students directly is lower than subsidy costs necessary for the Federal Government to provide student loans through private lenders under the existing system.[2] The Administration argued that related program savings could be passed on to students through reduced student interest rates or fees. Supporters also believed that a direct loan program would

---

[2]The U.S. Department of Education (ED) estimates that the subsidy costs of Direct Loans borrowed in FY1995 will be 5 cents for every dollar loaned. (ED. Office of the Undersecretary. *Direct Loan/FFEL Program Cost Update*. Sept. 1994.)

simplify loan delivery and servicing for students, and enhance program oversight because the complex web of guaranty agencies, banks and secondary markets would be eliminated under direct lending.

Few disagree that the existing FFEL loan program is both costly and complex, but there continues to be considerable debate over whether adopting direct loans is an advisable policy. Many continue to believe that reform of the FFEL program is preferable to implementation of a major new federally administered loan program. These opponents have questioned the accuracy of comparative cost projections showing significant budget savings. They further argue that cost estimates for direct loans crafted under Federal budget rules treat Federal administrative costs differently than guaranteed loans, resulting in understated direct loan administrative costs.[3] Opponents are also concerned about increases to the Federal debt that will be caused by the Government capitalizing some $20-25 billion in direct loans annually. They also question the capability of the Department of Education (ED) to manage a direct loan program, especially in light of consistent recent criticism from the General Accounting Office (GAO), the ED Inspector General, and the Office of Management and Budget (OMB) for its mismanagement of the FFEL and other student aid programs. Another concern is student access to credit during a transition period. Finally, there are concerns about potential consequences for Federal student aid programs if direct loans "don't work."[4]

This report analyzes the new direct loan program including the provisions for phase-in, important features such as borrower terms, repayment options, and the delivery system, and continuing questions and concerns both with respect to administration of the new program as well as the impact of the transition on the FFEL programs. The changes made to the FFEL program by the SLRA are not described here.[5]

PHASE-IN TO DIRECT LOANS

The SLRA established the new Federal Direct Student Loan Program (DL), beginning in academic year 1994-95. Federal Direct Student Loans parallel the FFEL program and include Federal Direct Stafford loans, subsidized and unsubsidized; Federal Direct PLUS

---

[3]The SLRA, as passed, was scored as providing $4.3 billion in savings over 5 years, including changes to FFEL as well as the DL program. All cost estimates use the pre-SLRA FFEL program for comparison. Depending on the economic assumptions used, and whether the budget scoring rules required by the Federal Credit Reform Act of 1990 were adhered to, costs for the switch from guaranteed to direct loans were variously estimated at savings of over $6 billion to no savings or even increased Federal costs. These varying cost estimates were a significant part of the political debate over adoption of a direct loan program.

[4]Arguments for and against direct loans are discussed in detail in: U.S. Library of Congress. Congressional Research Service. *Federal Family Education Loans: Issues Relating to a Change to Direct Loans*. CRS Report for Congress No. 93-327 EPW, by Charlotte Fraas. Washington, 1993.

[5]See: U.S. Library of Congress, *The Federal Family Education Loan Programs*.

loans; and Federal Direct Consolidation loans.[6] Under the new program, the Secretary of Education selects schools to participate in the direct loan program so that loans at such schools shall constitute 5% of total new student loan volume in academic year 1994-1995, 40% in academic year 1995-1996, 50% in academic year 1996-1997, 50% in academic year 1997-1998, and 60% in academic year 1998-1999. Beginning in the 1996-1997 academic year, the Secretary may exceed the specified percentage for direct loans if he or she determines it is warranted by the number of eligible schools wishing to participate.

Schools apply to participate in the direct loan program and the Secretary chooses participants among them. Schools selected to participate in the direct loan program must be reasonably representative of all schools according to certain characteristics such as loan volume, length of academic program, control of institution, geographic location and default experience. Participating schools -- either individually or as part of a consortium -- choose whether to originate loans for their students and must be specifically approved by ED for this purpose. Schools are to receive a fee from the Federal Government based on the number of borrowers for whom they originate loans. For students attending schools not choosing to originate direct loans or not approved for that purpose, loans would be originated by "alternative originators" under contract with the Federal Government.

Year 1

Over 1,000 schools applied to participate in the first year of the direct loan program. ED's selection criteria for 1994-95 included: participation in FFEL programs; a FFEL cohort default rate of less than 25% in either FY90 or FY91;[7] and, the capacity to participate electronically. Schools that wished to originate loans were also required to: participate in the Perkins Loan program;[8] not be at risk of losing FFEL or other title IV HEA student aid eligibility; and, not be subject to administrative actions as a result of financial or regulatory problems. Of the applicant schools, approximately 800 were determined to be eligible based on the participation criteria, and on Nov. 15, 1993, ED announced the names of the 105 schools selected to participate in the first year of the direct loan program, beginning July 1, 1994.[9] Of these schools, 41% are public

---

[6]The Improving America's Schools Act, P.L. 103-382, amended the HEA to rename the program the William D. Ford Federal Direct Loan program; Federal Direct Stafford Loans are renamed Federal Direct Stafford/Ford Loans.

[7]Note that this criterion is stricter than that used for continued FFEL institutional eligibility which requires a cohort default rate below 25% in 1 of the last 3 most recent fiscal years.

[8]Federal Perkins Loans are a separate program of need-based loans administered by participating schools and funded through Federal appropriations and institutional matching funds; this program is also authorized by title IV of the HEA.

[9]One school out of the 105 originally selected subsequently withdrew before the first year began. Currently 104 schools are participating in the first year of direct lending. At the time of passage of the SLRA, it was assumed that as many as 400 schools might participate in the first year of the program; however, due to the selection of several large public institutions with very high loan volume, the number actually selected was much smaller.

institutions; 23% are private, nonprofit institutions; and 36% are proprietary institutions. In terms of loan volume, public institutions represented 76%, private -- 18%; and proprietary -- 6%. Fifty-seven schools are originating loans directly while the others are using the services of an ED contractor for that purpose.

Not all of the first year schools chose to participate fully in the new program. ED gave schools the option of limiting their direct loan participation in various ways, for example -- freshman class only, new borrowers only, etc. Other student borrowers at these schools will continue to receive loans under the FFEL program. Sixty-eight of the first year schools chose 100% participation in the DL program; for the others the participation ranges from 10% to 98%.

The SLRA limited direct loan volume for all participating schools combined in the first year of the program to 5% of total Federal student loan volume; the estimate to be based on the most recent available loan data, in this case, FY91 FFEL loan volume. The 105 schools selected represented $729 million in FY91 FFEL volume taking into account the level of participation they selected for the direct loan program. In its announcement, ED estimated that these schools would account for more than $1 billion in loan volume in academic year 1994-95.[10] As of Dec. 8, 1994, ED data indicate that the first year schools had $476.8 million in booked loans (actually disbursed) and over $1.4 billion in loan originations.

Year 2

The SLRA contemplates a major expansion of the direct loan program in the second year with schools selected to represent 40% of new loan volume. Selection criteria for the second year also included the ability to participate electronically and evidence of administrative capability as well as the same default rate standard applied to year 1 schools. ED initially announced that the schools that had applied and been determined eligible for the first year, approximately 700, would automatically be considered for year 2 participation, and created a rolling application process with deadlines Mar. 30, July 1, and Oct. 1 of 1994. Subsequently the final deadline was extended until Nov. 1, 1994. Many schools may have waited to get some assessment of their initial experiences from year 1 schools before deciding if they wished to apply for the second year. ED announced school selections for the second year in May, June, and December 1994. The final list of 1,391 year 2 schools brings the total for participation in that year to 1,495.[11] Thus the schools participating in the direct loan program in the 1995-96 academic year represent

---

[10]The statute refers to academic years in setting volume caps for DL participation; most ED budget estimates for the loan programs are based on fiscal years which makes the estimation process more complicated.

[11]In announcing the final group of schools Dec. 1, ED also indicated that an additional 500 schools had applied. It is unclear whether the additional 500 represent all applicants, including some who may not be eligible, or only eligible applicants. Since ED has published regulations that somewhat ease the eligibility criteria for third and future years, i.e., allowing schools with a FFEL cohort default rate below 25% in 1 of the previous 3 years into the program, it is possible that these represent schools that would not have been eligible for year 2 but will be in the future.

about 20% of the approximately 7,000 schools in the FFEL program before the new program began.

Approximately half of the new schools selected for year 2 are proprietary institutions, but as was the case of those selected for year 1, public and private colleges and universities represent most of the loan volume. As was true in year 1, only some of the schools will originate loans directly, while the others will use alternate originators; however, ED has not released that information and does not plan to do so until the participation agreements are signed early in 1995. The level of participation in the DL program also varies; 895 schools will participate at 100%, while the rate of participation for the rest varies from 30% to 99%. Based on total FY92 data, the year 2 schools represent approximately $5.4 billion in loan volume. ED estimates of the total new loan volume for all participating schools in year 2, the 1995-96 academic year, are not currently available.[12] Table 1 provides summary data on combined year 1 and year 2 schools.

TABLE 1. Characteristics of Direct Loan Schools, Year 1 and Year 2

Type of School	Percent of schools	Total FY92 loan volume ($ in million)	Percent of total volume
Public	29	2,985.7	55.4
Private	23	1,588.2	29.4
Proprietary	48	823.3	15.2
Totals	100	5,397.2	100.0

Source: ED Direct Loan Task Force communication, Dec. 12, 1994.

IMPORTANT FEATURES OF THE PROGRAM

Loan terms and conditions for Federal Direct Stafford/Ford subsidized and unsubsidized Loans and for Federal Direct PLUS loans are generally the same as those in the guaranteed student loan or FFEL programs. The SLRA, which established the direct loan program, also made significant changes in FFEL characteristics.[13] The loan limits for direct subsidized and unsubsidized loans vary by year in school and dependency status,

---

[12]ED only provided total FY92 loan volume for these schools and did not estimate FY92 loan volume prorated for the school participation levels. Due to remaining questions about the loan volume for the new DL consolidation loans (discussed below) as well commitment levels, ED has not yet released DL volume estimates for the 1995-96 academic year.

[13]Details of the loan terms and conditions can be found in: U.S. Library of Congress, *The Federal Family Education Loan Programs*.

as listed in table 2. Independent students are eligible to receive the amount in the column for dependent students **plus** the additional unsubsidized amount.[14] Prorations of limits for shorter programs apply to fractions of an "academic year," which is defined in the HEA as a minimum of 30 weeks instruction in which a full- time student is expected to complete a minimum of 24 semester or trimester hours, 36 quarter hours, or 900 clock hours. After the first year, the proration is based on the portion of the academic year that remains to complete a student's program. Parents of dependent students can borrow a PLUS loan up to the cost of education minus the student's other financial assistance.

Interest rates are variable and are adjusted annually. The maximum interest rate is 8.25% for Direct Stafford/Ford loans and 9% for Direct PLUS loans. Currently the interest rate for Direct Stafford/Ford Loans is 7.43% through June 30, 1995; for Direct Plus Loans, the current rate through June 30, 1995, is 8.38%. Direct Loans, like FFEL loans, have an origination fee of 4%.

[14]Dependent undergraduates may be eligible to receive the larger unsubsidized Stafford loan limits available to independent students if the financial aid administrator determines that exceptional circumstances would preclude the student's parent(s) from borrowing a Federal PLUS loan to meet the family's expected family contribution to the student's college expenses and if the family is otherwise unable to pay the expected contribution.

TABLE 2. Federal Direct Stafford/Ford Loan Limits

Academic level	Dependent student	Independent student	
	Total subsidized & unsubsidized	Plus additional unsubsidized only	Total amount
Annual Limits			
First-year undergraduate			
Full year	$2,625	$4,000	$6,625
2/3 up to full year	$1,750	$2,500	$4,250
1/3 up to 2/3 year	$ 875	$1,500	$2,375
Second-year undergraduate			
Full year	$3,500	$4,000	$7,500
2/3 up to fuil year	prorated	$2,500	prorated
1/3 up to 2/3 year	prorated	$1,500	prorated
Third-year/remainder undergraduate			
Full year	$5,500	$5,000	$10,500
Less than full year	prorated	prorated	prorated
Graduate/Professional Student	$8,500 subsidized + $10,000 unsubsidized = $18,500		
Aggregate Debt Outstanding			
Undergraduate	$23,000		$46,000
Graduate/Professional	$65,500 subsidized + $73,000 unsubsidized = $138,500 (including undergraduate loans)		

Repayment Options

A major aspect of the new law provided different types of repayment plans for direct loan borrowers. The Secretary must offer four alternatives: standard; graduated; extended; and income-contingent repayment. These plans are described below. If the borrower does not chose a repayment plan, the Secretary is authorized to select one on his or her behalf, but may not select income-contingent repayment. Defaulted borrowers of direct or guaranteed loans may also be required to repay through an income-contingent plan. Also, other alternatives for repayment may be provided by the Secretary on a case-by-case basis to accommodate a borrower's unique circumstances. Under regulations issued by the Secretary for the program, direct loan borrowers who do not choose a repayment plan will repay under the standard repayment plan; borrowers will, in general, be allowed to change repayment plans at any time.[15] Direct loan borrowers are eligible

[15]For the final regulations on the Direct Loan program repayment options for the second and further years of the program, see: *Federal Register*, Dec. 1, 1994. p. 61662-61713, which differ from year 1 rules primarily with respect to the income-contingent repayment option. The income-contingent repayment rules for year 1 were recently revised by ED to parallel those for year 2 and thereafter; see: *Federal Register*, Dec. 22, 1994. p. 66132-66137.

for the same repayment relief as FFEL borrowers, including deferments and forbearance. Previous FFEL borrowers whose schools participate in the direct loan program are considered to be eligible under the direct loan program for those deferments available when they took out their FFEL loans, i.e., they will be treated as old borrowers are under the FFEL program.[16]

Under the **standard** repayment plan, borrowers make fixed monthly payments of at least $50 for up to 10 years, the same as the standard repayment plan under the FFEL program.[17]

Under the **extended** repayment plan, borrowers make fixed monthly payments of at least $50 for a period of time that varies depending on the amount of the loan. These terms are:

less than $10,000 -- 12 years;
$10,000 but less than $20,000 -- 15 years;
$20,000 but less than $40,000 -- 20 years;
$40,000 but less than $60,000 -- 25 years; and
$60,000 or more -- 30 years.[18]

Under the **graduated** repayment plan, the borrower makes fixed monthly payments at two or more levels (usually a lower amount for the early years of repayment and a larger amount in the later years) over a period of time that varies with the size of the loan and is the same as for the extended repayment plan; further, the borrower's payments may not be less than the interest due or less than 50% of the monthly payment required under the standard plan or more than 150% of the monthly payment under the standard plan.

Finally, under the **income-contingent** repayment plan, the borrower annually repays an amount based on the total amount of the borrower's Direct loan, adjusted gross income, and family size for a period up to 25 years (income-contingent repayment would not be available to PLUS loan borrowers).

---

[16]Initially, ED had published regulations that treated all DL borrowers as new borrowers and thus only eligible for the categories of deferments available after the 1992 HEA amendments. This was of particular concern to medical students whose automatic eligibility for deferments based on residency or internships was eliminated in 1992 for new borrowers. The DL regulations have now been revised so that medical students who have outstanding FFEL balances continue to have the pre-1992 deferments. See: U.S. Library of Congress, *The Federal Family Education Loan Programs* for further details.

[17]Because of the variable interest rate, the Secretary may adjust either the size of the monthly payment or the length of the repayment period annually. If the change in interest rates would result in a borrower being unable to complete repayment within the 10-year maximum, the Secretary may provide administrative forbearance for a maximum of 3 years (effectively extending the repayment period).

[18]These amounts and repayment periods parallel those for the Consolidation Loans under the FFEL program. As with the standard repayment, the Secretary may adjust the fixed monthly amount or the repayment term to take into account the impact of variable interest rates.

Income-Contingent Repayment Plan Provisions

Income-contingent repayment is a politically attractive component of direct loans (or any loan program) that is complex and difficult to operationalize to everyone's satisfaction. Different types of income-contingent loan repayment schemes have been proposed for many years, beginning with a proposal by Milton Friedman almost 40 years ago. In designing a plan, policy makers have to consider many variables including the payback rate, definitions of income subject to the rate, the maximum amount of debt, the amount of subsidy and which borrowers will be subsidized, all of which are interrelated and have an impact on the costs to the Federal Government of such a plan.[19]

On July 1, 1994, ED published final regulations for the income-contingent repayment plan in effect for borrowers whose direct loans enter repayment on or after July 1, 1995. These rules include the following key provisions. A borrower's annual payment (divided by 12 for the monthly amount) is based on a percentage of the borrower's adjusted gross income that varies from 4 to 15% depending on the size of the debt. The rate is 4% for $1,000 or less of debt and increases by 0.2% for each additional $1,000 up to the 15% maximum.[20] However, a borrower's monthly payment is capped at 20% of *discretionary* income (defined as adjusted gross income minus the poverty level for the borrower's family size as published annually by the U.S. Department of Health and Human Services).[21] If the monthly payment is less than $15, the borrower is not required to make a payment. Borrowers may choose a second option under the income-contingent repayment plan called the "capped amount," under which the borrower repays monthly no more than the amount that they would repay under a standard amortization plan with a 12-year repayment term.[22]

Under the income-contingent repayment plan, special rules apply for married borrowers who file joint income tax returns and apply to repay jointly. If the loan has not been repaid in full by the end of the 25-year repayment period, the remaining debt is cancelled by the Secretary. Under current tax laws, the amount of debt forgiven would be considered income to the borrower and would be taxed as such.

Under this income-contingent formula, the amount a borrower is required to pay monthly may not equal the accrued interest on his or her loan; when this happens, the unpaid interest is added to the principal amount, i.e., capitalized. This is also referred to

---

[19]For a discussion of the variety of issues involved in designing an income-contingent loan program, see: Congressional Budget Office. CBO Memorandum. *Issues in Designing a Federal Program of Income-Contingent Student Loans*. Washington, Jan. 1994.

[20]Thus, the **rate** is progressive with debt not income, but the actual monthly payment will obviously be larger for those with higher incomes, given the same debt level.

[21]*HHS Poverty Guidelines for All States (except Alaska and Hawaii) and the District of Columbia.* Currently, for a family of one, the HHS poverty guideline is $7,360.

[22]The capped amount alternative allows borrowers the choice of capping their monthly payment amount regardless of income.

as negative amortization. The rules for the income-contingent repayment plan provide that such capitalization shall not exceed 10% more than the original principal amount, after which interest continues to accrue and must be paid, but is not capitalized (i.e., the principal amount cannot increase to more than 110% of the original loan).

Internal Revenue Service (IRS) involvement in the income-contingent plan is limited to disclosure of borrower tax return information to the Secretary to enable ED to calculate repayment amounts annually. In the conference report for the SLRA, managers requested the Secretaries of Education and Treasury jointly to develop a plan for additional IRS involvement in student loan collections, including an analysis of the feasibility of such a task and its effects on the operations of IRS and the management of student loan collections. The plan, to be submitted to Congress within 6 months of enactment of the SLRA, was to include the results of the analyses and legislative recommendations. Although the report has been completed, it has not yet been released.

The SLRA required negotiated rulemaking for development of the DL program rules for academic year 1995-96 and thereafter, including the features of income-contingent repayment described above. Development of the income-contingent repayment plan was particularly controversial during these negotiations. The Administration sought to make the plan as attractive as possible to borrowers to fulfill the President's campaign promise to make it easier for students to pay off loans and therefore pushed to keep the percentage of income assessed and the monthly payment amounts as low as possible. At the same time, an important consideration for the Administration was attempting to keep the proposed plan essentially cost neutral, i.e., not increase the subsidy rate over that without an income-contingent repayment option. Others, including many in the higher education community and student group representatives, were concerned that too low monthly payment amounts would tempt students into paying excessive amounts of interest over the life of the loan and even going further into debt because of negative amortization.

Aside from more fundamental differences over the design of such a plan, which have by no means been resolved, during negotiated rulemaking, the most contentious issues included: how to insure that truly low-income borrowers were not paying too much of their discretionary income (especially since the payback rate proposed by the administration was assessed on the first dollar of income); whether some consideration should be given to family size, particularly for low-income borrowers; what the limit should be on capitalization of interest; and how to treat repayment terms for married borrowers to avoid a marriage penalty. In reviewing proposed alternatives during the course of negotiations, those participating were particularly interested in the average length of repayment, the percent of borrowers that would fail to repay in 25 years, and the percent of borrowers subject to negative amortization resulting from different proposals.

According to ED estimates, under the current plan, the average length of repayment is estimated at 14 years, approximately 12% of borrowers would not repay within the 25-year period, and 52% of the borrowers selecting income-contingent repayment would be subject to negative amortization during some portion of the repayment cycle. It should be noted that the income-contingent plan is only one of the repayment options, and ED currently estimates that 18% of borrowers will select income-contingent repayment.

Consolidation Loans

Direct loan borrowers may combine their direct loans, as well as guaranteed and other student loans[23] into a Direct Consolidation loan under terms and conditions established by the Secretary beginning in the 1995-1996 academic year. In addition, FFEL borrowers may obtain direct consolidation loans from the Secretary if the borrower is unable to obtain a FFEL consolidation loan from a lender or obtain such a loan with income sensitive repayment terms acceptable to the borrower.

In October 1994, ED announced its plan for implementation of the Federal Direct Consolidation Loan Program. As allowed by the statute, ED chose not to make the terms and conditions of Direct Consolidated Loans the same as those for FFEL Consolidation. Instead of a fixed interest rate based on the average of the loans consolidated as in the FFEL program, Direct Consolidation loans will have the same variable rate and interest caps as Direct Stafford/Ford or Direct Plus loans. In addition, Direct Consolidation borrowers will be able to choose any of the four repayment options (with the exception that PLUS borrowers are not eligible for income-contingent repayment).

Borrowers in default on a FFEL or DL who have made satisfactory arrangements to repay or who agree to repay under the income-contingent repayment plan may also consolidate their defaulted loans; such borrowers are required to pay under the income-contingent plan for at least 3 months before becoming eligible to select another repayment option. Collection costs are assessed and added to the principal for defaulted loans that are consolidated.

Borrowers obtain information and applications from the Secretary to obtain Direct Consolidation loans; in conformity with statutory requirements, FFEL borrowers who wish to consolidate under the Direct Loan program must assert they were unable to obtain a FFEL consolidation loan with income sensitive terms acceptable to them.

The Administration's announcements regarding the Direct Consolidation Loan program aroused considerable concern. Because of the more favorable interest rates and potentially lower monthly payments under the additional repayment options, the potential exists for a dramatic shift in loan volume with large numbers of FFEL borrowers switching into the Direct Loan program, causing problems for lenders, secondary markets and guaranty agencies that could subsequently have an impact on continuing access to FFEL loans during the transition period.[24] In December 1994, in response to concerns

---

[23]The basic requirement for consolidation is that the borrower has outstanding loan principal from one or more of the following programs: Federal Direct Stafford/Ford loans or Federal Direct PLUS loans; FFEL loans, including Federal Stafford loans, Federal SLS loans (or ALAS loans), Federal PLUS loans, and Federal Consolidation loans; Federal Perkins Loans (or NDSLs); and/or Health Professions Student Loans (HPSLs), Health Education Assistance Loans (HEALs), and Public Health Service Act Nursing Loans.

[24]Following the ED announcement about Direct Consolidation Loans, a number of congressional leaders wrote a letter to the Secretary expressing concern about plans for the Direct Consolidation program and urging ED not to endanger the continued availability of FFEL loans for current students and parents through implementation of the DL consolidation program.

that had been expressed, ED announced that it was reassessing its plan for Direct Consolidation Loans and would develop a 6-month plan for "phasing-in" the new program (to be released in January 1995). In the meantime, selected borrowers from among those who initially called to request information about the DL Consolidation program will be used as a "sample" to learn more about the characteristics of potential DL Consolidation loan borrowers and application and processing operations.

Program Administration

The SLRA provides that students and parents would be entitled to loans for the student's attendance at a participating school, but schools would specifically not have a right to program participation. Institutional eligibility for year 3 and thereafter is the same as for the FFEL program. ED regulations allow the Secretary to select among eligible applicants based on obtaining reasonable representativeness of all schools among those participating in the Direct Loan program and to assist in assuring a smooth transition from the FFEL program to Direct Loans.

The Secretary is authorized to contract for origination, servicing, collection, data systems and sundry services connected with the implementation of direct loans. Contractors may include guaranty agencies and lenders participating in the guaranteed loan programs, but must have extensive experience and a demonstrated record in loan servicing and collection. To the extent practicable, special consideration for contracts must be given to State guaranty agencies with an exemplary record. State agencies may apply for contracts as a consortium. Contracting must comply with all appropriate Federal laws and regulations.

An initial contract for all origination and servicing, accounting and collection functions for an initial 21-month period was awarded at the end of 1993.[25] In September 1994, ED announced it planned to have separate contracts for origination and servicing. Multiple servicing centers will be contracted for in 1995, to be in operation by the 1996-97 academic year. There will be a single, separate contract for the origination function.

Important new school functions in addition to those performed by schools in the FFEL program may include: 1) obtaining a completed, accurate, signed promissory note to be sent to the Direct Loan servicer; and 2) performing funds management, including accounting for all loan funds disbursed and reconciling accounts on a monthly basis with the loan servicer. Federal funds for direct student loans are delivered to participating schools and students in essentially the same manner as Pell Grants,[26] and other fiscal control and record keeping practices by schools are the same for all HEA Title IV programs. ED has developed loan origination software and training for schools, as well

---

[25]The contract, which ends June 30, 1996, was for $91 million and was awarded to a consortium of firms headed by CDSI, a computer firm located in Rockville, Maryland.

[26]For a description of the Pell Grant delivery system, see: U.S. Library of Congress. Congressional Research Service. *The Federal Pell Grant Program.* CRS Report for Congress No. 94-532 EPW, by Margot A. Schenet. Washington, 1994.

as entrance and exit counseling materials. The contractors are responsible for processing requests for deferment/forbearance, credit checks, and other loan servicing and collection functions.

To enhance financial controls and accountability, ED has set up three levels of loan origination; standard origination, under which schools have the least responsibility and control over funds; and two levels of school origination or options. Schools must meet additional criteria beyond those for participating in the DL program to have full authority to originate loans. Any school eligible to participate in the Direct Loan program may operate under the "standard origination" option, in which case the loan servicer, not the school, is responsible for preparing the promissory note, obtaining the completed note from the borrower, and initiating the drawdown of funds for the school to disburse to the student. To be eligible for either of the two school origination options, which allows schools greater control over funds, institutions must meet additional criteria that include: participating in the Perkins Loan or Pell Grant program or a similar graduate program;[27] not being on the reimbursement system in the Pell Grant program; and demonstrating fiscal responsibility, as determined by the Secretary. The Secretary has the authority under the final regulations, based on evaluation of a school's performance, to require a change to standard origination.

Under school origination option 1, the school would be responsible for the promissory note, but the servicer would continue to be responsible for initiating drawdown of funds; under school origination option 2, the school would have full responsibility for all aspects of the origination function, including determining fun 'ing needs and initiating funds drawdown. Schools that perform the origination function under options 1 or 2 will be paid a fee, averaging $10 per borrower for years 1 and 2. ED has not issued regulations on calculation of the administrative fee for future years, but will evaluate the experience of year 1 and year 2 schools to determine administrative costs and the impact of borrower volume on costs. Schools operating under the standard origination receive no fee.

The common financial reporting form, the Free Application for Federal Student Aid (FAFSA) serves as the form for students to apply for Direct Loans, and the Secretary provides a common promissory note and loan disclosure form. Direct loans are disbursed to students by first applying the loan to the student's account with any remainder being disbursed to the student. The requirement of the FFEL programs for a 30-day delay in the distribution of loan proceeds to first-year first-time borrowers also applies to Direct Loans. Direct PLUS loans to parents of dependent students would be subject to multiple disbursement, which has been required to date only for the Federal Stafford and SLS loans under the FFEL programs.

Under the new law, funds for Federal administrative costs (program operations by ED, servicing contracts, etc.) for Direct Loans are mandatory spending with a permanent appropriation. Such costs for Federal credit programs are customarily discretionary.

---

[27]Under the first year rules, only schools that participated in the Perkins program were eligible for complete origination responsibilities; the final rules for the second year and thereafter significantly expand the pool of eligible institutions by only requiring Pell Grant program participation.

Spending for administrative costs, which has specific annual authorizations under P.L. 103-66, over a 5-year period (FY1994-FY1998) is, however, capped at a total of $2.5 billion, essentially the same as proposed for the full phase-in to direct loans in the original Administration bill. The Secretary of ED is required to provide a detailed description of the expenditure of administrative funds in the annual budget justification sent to appropriations committees. The Secretary must also notify authorizing and appropriations committees if annual administrative expenses must be drawn from the future year's authority. The FY1995 budget justification from the ED included 350 full-time equivalent staff and $66.7 million in contracting costs for DL administration. The specific annual authorization for FY1995 is $345 million, rising to $500 million in FY1996. ED notes that more than half the direct loan administrative costs in FY1995 are for transition support, including $152 million for administrative expense allowances for FFEL guaranty agencies.[28]

IMPACT AND CONTINUING ISSUES

The introduction of the new Direct Loan program has given rise to a variety of concerns, not only from those who opposed its adoption, but from many who are concerned about its impact on the general availability of loan aid for students and who have concerns about whether ED can successfully avoid pitfalls in its implementation.[29] For the most part, little independent evidence exists to evaluate the significance of these concerns at this point in time.

Acce

A number of provisions were enacted in the SLRA to attempt to insure that students would continue to have access to loans during the transition period from the FFEL to the DL programs. The main concern was the likelihood of banks and guaranty agencies pulling out of the FFEL program because of losses of volume and profitability before Direct Loans are available to most students. Provisions for "lender of last resort" loans are intended to prevent this problem.[30] Most observers have agreed that the FFEL program will experience significant consolidation; at present, however, it is unclear what the parameters are likely to be, particularly since the expansion of eligibility and loan limits in the 1992 HEA amendments have led to a huge increase in FFEL volume; the first year DL volume is limited to 5%; and, some changes reducing lender profits (i.e., reduction in the interest subsidy) do not take effect until 1995. It is likely that a clear estimate of any impact on access will not be available until mid 1995 at the earliest.

---

[28]For further description of the guaranty agency allowances, see: U.S. Library of Congress, *The Federal Family Education Loan Programs*, p. 25.

[29]For a discussion of the issues raised by supporters and opponents prior to passage of the SLRA, see: U.S. Library of Congress. Congressional Research Service. *Federal Family Education Loans: Issues Relating to a Change to Direct Loans*. CRS Report for Congress No. 93-327 EPW, by Charlotte Fraas. Washington, 1993.

[30]The transition provisions are described in detail in: U.S. Library of Congress, *The Federal Family Education Loan Programs*.

In the meantime, during the first year of direct lending, a few guaranty agencies have closed or have announced that they are moving in that direction, including Puerto Rico, Mississippi, Idaho, Virgin Islands, and Maryland. A number of others have been reported to be experiencing some difficulties. Early in 1994, ED had estimated that when year 2 begins, as many as 20 guaranty agencies may see their volume fall by 40% or more, because of the schools switching to direct loans. That estimate was based on FY92 loan volume however; since volume has increased so significantly since then, the accuracy of the estimate may be questionable. Similarly, although some banks have withdrawn from the FFEL program, it is unclear what impact the DL program will have in the immediate future. A recent banking industry survey indicated that many banks see increased loan demand offsetting the DL competition in the next few years.[31]

A FFEL industry group, the Coalition for Student Loan Reform, has used the competition from the DL program to argue for consolidation, simplification and cooperation in the FFEL program in order to offer competitive terms to students to compete with the new program. In this sense, a decrease in the number of lenders and guaranty agencies may improve the efficiency of the FFEL program and reduce complexities; ironically, this was one of the main reasons supporters gave for adoption of the DL program in the first place. Suggested FFEL improvements have included providing more services to schools by guaranty agencies, sharing of computer and electronic data systems, and offering some borrowers more advantageous terms by reducing fees or interest rates.

Implementation/Fraud and Abuse

Under the SLRA, the existing Advisory Committee on Student Financial Assistance is required to advise the Secretary and Congress on the implementation of the Direct Loan program and the FFEL programs. The Advisory Committee is also requested to evaluate the student loan programs and report annually, and to issue final recommendations regarding full implementation of direct lending to the Secretary and Congress by Jan. 1, 1997. The first annual report issued by the Advisory Committee focused on program design and implementation activities and raised a number of concerns, many of which had been raised earlier concerning implementation of the program. Of particular concern is the potential for fraud and abuse by institutions and students because of the possibility of students receiving multiple Direct Loans for the same enrollment period from different institutions. The Advisory Committee also raised questions about ED's intention to rely on the national student loan data system for tracking and managing DL loan data when it was not designed for such tasks; the potential for problems in ED's communications with DL schools; and, concern about ED's ability to train new DL schools in the program's requirements, particularly as the number of schools expands so significantly in year 2.[32]

---

[31]As reported in: *Education Daily*, Sept. 20, 1994. p. 4.

[32]*Implementation of the Federal Direct Student Loan Program and Modifications to the Federal Family Education Loan Program.* A Report of the Advisory Committee on Student Financial Assistance. Washington, Aug. 1994. For earlier versions of the same concerns, see: U.S. House of Representatives. Committee on Government Operations. *Managing the Federal Direct Student Loan Program.* Hearing before the Human Resources and Intergovernmental Relations Subcommittee, June 10, 1993. 103d Cong., 1st Sess. Washington, GPO, 1994.

A related concern about the potential for fraud and abuse has been raised with respect to the rules ED has promulgated for school eligibility for complete control of loan origination functions and thus access to Federal funds. Those concerned believe the significant expansion in the pool of schools eligible for school origination in year 2 and future years will lead to abuse. ED has contended that the additional quality standards included in the rules for who can serve as an originator plus the fact that ED has final say over the level of origination will prevent fraud and abuse. In addition, ED has contended that many critics concerned about abuse as more schools participate in the DL program have failed to take into account the significantly increased institutional eligibility standards and reviews added by the 1992 HEA amendments.[33]

Costs and ED Administration

While few disagreed that the guaranteed loan system was too complex and costly as it operated prior to passage of the SLRA, differences continue over whether the appropriate course for Federal policy is direct loans, requiring an expansion of government's role, or changes to improve the guaranteed loan system. These differences continue to be reflected in broad concerns about the costs involved and the ability of ED to administer the program, particularly as the number of schools and loan volume increases sharply from year 1 to year 2. Arguments continue over the estimates of **true** costs of the program (see above). Administrative costs currently appear to be within the authorized maximums, but many administrative issues that could impact on such costs have not been resolved. ED has not yet put into place final contracts for origination and servicing for year 3 and beyond; the student loan data system is not yet fully operational; and, a new formula for paying a cost allowance to guaranty agencies during the transition has not yet been determined.

ED has responded to some of these concerns by pointing to the apparently smooth operation of the program during year 1 and has called on year 1 schools to vouch for the program's success. While year 1 schools have generally praised ED's administration of the new program, many of the most complicated administrative tasks for schools and ED, such as funds reconciliation, loan servicing, and collections have just begun or have not yet been initiated. Critics have also suggested that ED is raiding staff of other programs to ensure success in the DL program and that problems may begin to surface elsewhere in the department as other programs suffer depleted administrative resources as well as in the DL program when the number of schools increases more than tenfold in year 2.

---

[33]For further information on the increased integrity provisions, see: U.S. Library of Congress. Congressional Research Service. *Institutional Eligibility: The Higher Education Amendments of 1992.* CRS Report for Congress No. 93-861 EPW, by Margot A. Schenet. Washington 1993.